

**MEDIATION IN BANKRUPTCY -  
WHY JUST IN THE MINI CHAPTER 7  
AND MEGA CHAPTER 11 CASES?**

By

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Mediation of disputes is hardly a new idea. It has been embraced enthusiastically by just about all federal and state courts. That includes bankruptcy courts in theory, but less so in practice.

Many bankruptcy courts have established mediation programs informally or by local rule. *See, e.g.*, Local Bankruptcy Rule 7016-6, Southern District of California. Mediation programs such as that operated in San Diego, rely on uncompensated volunteers to mediate small disputes in Chapter 7 cases, typically discharge/dischargeability complaints. And they work. The overwhelming number of these complaints are settled in mediation. San Diego also has a panel of compensated mediators. Mediation training is required before one can be admitted to the compensated panel. That panel now numbers about 6, and no one in San Diego can remember any mediation assignment to a member of that compensated panel.

At the other end of the spectrum are the mega-cases - most frequently filed in Delaware. There, among the usual "first day orders" may be an Alternative Dispute Resolution Order. These ADR orders are comprehensive, running to 50 pages and more. *See, e.g., In re Sun Healthcare Group, Inc.*, Case No. 99-3657, U.S. Bankruptcy Court, District of Delaware. Typically, non-judicial mechanisms are set up to resolve tort and other claims. Not so typical, even in Delaware, is mandatory mediation of plan formulation.

ADR in the small Chapter 7 and big Chapter 11 cases permits prompt dispute resolution at a reasonable cost that otherwise would not be achievable.

Now, let's look at the middle of the spectrum, the small, medium or large, non-public company Chapter 11 cases. It is these cases that have been giving bankruptcy reorganization a bad name. They are extraordinarily complicated, thanks to a Code and Rules that give every party something to litigate about (and most parties and their lawyers do litigate). Consequently,

they are outrageously expensive. Since the debtor has to pay for most of the attorneys and other professionals, administrative charges can and do sink many Chapter 11 debtors. And these Chapter 11 cases are notoriously unsuccessful. It is estimated that about 10% of Chapter 11 cases result in a confirmed *and* performed Chapter 11 Plan.

Construction defect litigation is multi-party litigation that is invariably sent out to mediation by courts in California. Why? Simply because trials are just too complicated and expensive. They overburden the courts; they overburden parties who, with their lawyers, must sit through interminable trials to listen to evidence that does not relate to them; and they end in a result generally not satisfactory to the parties.

Chapter 11 plan formulation and confirmation is the epitome of multi-party litigation. Yet, generally speaking, mediation of disputes in Chapter 11 cases is virtually non-existent according to responses to the author's inquiry from lawyers and judges in Los Angeles, Chicago, New York, Dallas, Denver, Miami and elsewhere. Instead, inordinately complicated and protracted trials on plan confirmation typically take place; the court is overburdened, along with the clients and lawyers who must sit through motions and trial testimony that may not directly affect them; and the result is generally not satisfactory to one or more parties who, often, appeal orders and judgments.

Why? The short answer is that mediation is simply not yet part of the bankruptcy culture. But that does not fully answer the question.

I am compelled to relate a story that may contain a disturbing reason, at least as far as some lawyers are concerned. At a recent ABI annual meeting in Washington, D.C., I attended the reception at the United States Supreme Court. I had a conversation with an experienced Chapter 11 lawyer whose name and domicile shall remain nameless. During our conversation I touted my idea that using mediation in Chapter 11 would result in more plan confirmations in shorter times and at lesser costs. I was stunned at his reply: "No, it won't work. When we get hired by a committee or creditor, we expect to make some money. You can't do that by mediating."

That this notion may be widespread among an element of the bankruptcy bar, is reflected in the feeding frenzy that takes place when a Chapter 11 case is filed. It is standard practice for some lawyers to monitor Chapter 11 filings daily, and to scan the list of creditors in newly filed Chapter 11 cases. What follows then probably violates anti-solicitation ethical rules in most jurisdictions. Lawyers scramble to find a client in the Chapter 11 cases, especially a committee. Having acquired a client, they set about exercising all the rights given their client by the Bankruptcy Code.

Courts are supposed to oversee this hard-charging (pun intended) activity, and they do the best they can. *See, e.g., In re Auto Parts Club, Inc.* 224 B.R. 445 (Bkrtcy S.D.CA (1998), where the creditors committee counsel was seriously dinged for churning. I have not heard (yet) of an objection to the appointment of committee counsel based on the ground of unethical

solicitation. So long as the game is litigation, Chapter 11 litigation costs will soar and, as a practical matter, they will be limited only by the funds available to pay fees.

The Bankruptcy Code provides rights to every party to a Chapter 11 case. The theory is that the uncertainty caused by conflicting rights will encourage parties to negotiate and settle. Unfortunately, the theory doesn't work. Where parties can, their lawyers will litigate.

Think about the kinds of activities in Chapter 11 bankruptcy cases that generate high fees: cash collateral disputes, motions for relief from stay by landlords and secured creditors, and particularly, objections to disclosure statements and objections to plan confirmation. Each one of these conflicts is in reality a mini, or not so mini, lawsuit. Is there anything unique about them that makes them unsuitable for the same mediation as routinely done in lawsuits in state and federal courts? If mediation can be used successfully in multi-party cases such as construction defect litigation, it can be used successfully in Chapter 11 cases, each one of which comprises multiple, multi-party litigations.

There is no obstacle to using mediation in bankruptcy court, even court mandated mediation. The Alternative Dispute Resolution Act of 1998, (28 U.S.C. §§ 651 *et. seq.*) requires district courts to authorize use of ADR in civil actions, including adversary proceedings in bankruptcy. In fact, district courts, and by extension, bankruptcy courts are authorized to require mediation or early neutral evaluation, even without the parties consent.

Why then, hasn't mediation, although authorized by statute, been implemented generally in Chapter 11 cases? Primarily because it has not yet become part of the Chapter 11 legal culture in most bankruptcy districts; and secondarily because neither bankruptcy judges nor bankruptcy lawyers are promoting it. Remember, mediation was not generally a part of the legal culture 15 years ago. Underfunded state courts were forced to find alternatives for resolving cases that were taking too much time and wasting too many scarce judicial resources. To a large extent, mediation and other forms of ADR were forced on the bar by the bench and state legislatures. *See, e.g.*, California's mandatory early mediation pilot program, Cal. Code of Civil Procedure §§1730 *et. seq.*, and the implementing Mediation Pilot Program Rules, Cal. Rules of Court 1640 *et. seq.*

For some reason, ADR has been late coming to the bankruptcy practice. I am not so cynical to believe that most practitioners, at least the busy ones, want to avoid mediation so as to keep their fees high. In fact, I think, based on my experience as a Chapter 11 debtor's lawyer, that most bankruptcy lawyers are bright, honest, ethical lawyers. I also think that most bankruptcy lawyers realize, at least subconsciously, that they must find ways to cut chapter 11 administrative costs lest Congress instead do the job with a meat ax.

Some courts assert and exercise the power to make mediation mandatory. An example is the probate mediation program in Los Angeles. Others decline to order mandatory mediation, leaving it up to the lawyers to agree to it. An example is the San Diego probate program as it existed through 2003. By no accident, the Los Angeles program works, while the San Diego one

lay moribund until this year when its mediation program became mandatory. I suggest that mediation in bankruptcy cases, subject to the discretion of the bankruptcy judge, ought to be mandatory.

Mediation can accomplish many things a trial judge cannot. Client satisfaction is one of them. Typically, all parties emerge from a mediation pleased with the result. That is never the result after a trial. Getting to the root causes of a problem are another. Dealing directly with obstacles to settlement helps resolve conflicts. Emotions frequently hinder Chapter 11 progress as they do resolution of all manner of disputes. Mediation literature refers to the emotional barriers as "blocking issues." It is a simple fact that lawyers usually can resolve the legal and economic issues; but lawyers for the parties are often not able to deal effectively with the blocking issues. Mediation training enables the mediator to identify and resolving them, leading to settlements not attainable in court.

There is no need to make the case for mediation. Mediation is inexorably becoming part of the fabric of dispute resolution in trial courts in all jurisdictions. It is time the bankruptcy professionals likewise stop litigating and start mediating; and it is time the bankruptcy courts encourage them to do that.